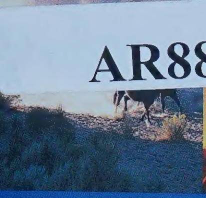
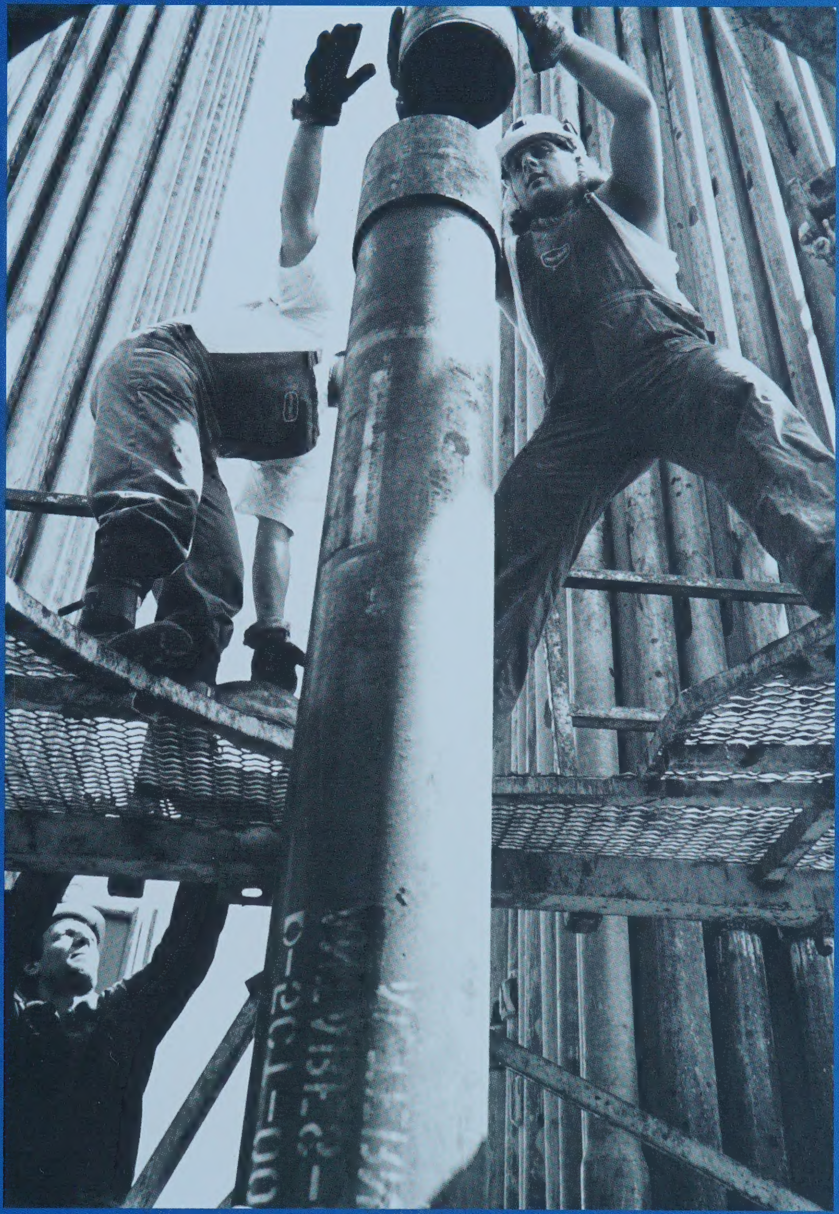





KROES Energy Inc.



2005
ANNUAL REPORT

FINANCIAL HIGHLIGHTS /	2005	2004
Oil production (Bbls/day)	246	241
Net revenue	$ 3,674,683	$ 3,262,956
Earnings	$ 806,414	$ 756,834
Earnings per share*	0.024	0.023
Cash flow	$ 1,289,545	$ 1,031,222
Cash flow per share*	0.039	0.032
Working capital	$ 1,465,019	$ 1,986,720

* *Fully diluted weighted average*

CORPORATE PROFILE / Kroes Energy is a junior oil and gas producer with a major oil field redevelopment project in Ukraine (Eastern Europe's fastest growing economy), and minor production in Trinidad. The Company recently diversified into oil and gas exploration and development in Western Canada. Kroes has a strong management team with extensive international and domestic experience. Shares trade on the TSX Venture Exchange under the symbol KRS.

ANNUAL GENERAL MEETING / The 2006 Annual General Meeting of the Shareholders will be held in Calgary, Alberta on June 19th at 3:00 p.m. (Mountain Daylight time) in the Cardium Room at the Calgary Petroleum Club located at 319 - 5th Avenue S.W.

Report to Shareholders

RESULTS FOR 2005

Net earnings for 2005 amounted to $806,414, an increase of 6.5% from the prior year. Revenues from the Company's Ukraine and Trinidad production increased primarily due to higher prices but new royalties established during the year in both countries took a significant portion of the revenue gain, and operating costs were higher. Cash from operations totalled $1,289,545, a gain of 25% from the prior year. On a per share basis, net earnings were 2.5 cents and cash from operations was 4.0 cents.

Capital expenditures for the year were all related to the Company's Ukrainian project and totalled $1,773,450 for the drilling and completing of three wells together with the associated gathering and processing facilities. Comparative capital spending in 2004 was $1,848,826.

The oil field development program in Ukraine continues through Kroes' 45% owned joint venture Kashtan Petroleum Ltd. Production declines experienced in 2004 were reversed and annual average production was up slightly at 241 barrels per day. However, Kroes' share of volumes grew through 2005 to exit the year at 262 barrels per day compared with 220 barrels per day at the end of 2004.

DEVELOPMENTS IN UKRAINE

Political uncertainty persists in Ukraine as the new administration that was elected early in 2005 struggled to change the bureaucracy; began the process of moving toward greater transparency; attempted to gain acceptance by its democratic neighbors in Europe; and juggled its relationship with Russia. The country has considerable oil and gas potential yet only satisfies some 25% of its needs, with the rest being imported from neighboring producers, especially from Russia. Inexperience in natural resource management is evident as the government has done nothing to encourage exploration and development of its resources and, in fact, introduced a punitive new production royalty that began modestly early in 2005 but was increased on two occasions during the year with the final increase bringing the rate to approximately 41% late in December. This onerous tax, when combined with a Value Added Tax of 20% that is applied to all sales revenues, reduces producers' revenues by more than 60%. Fortunately, there is no additional government take respecting the Lelyaki oilfield (other than income taxes) and with the current level of oil prices, Kashtan Petroleum Ltd. still will generate sufficient cash flow to drill two or three new wells each year. This should allow production and cash flow to increase steadily. However, the profitability of the project would be at serious risk should there be a significant drop in future oil prices. The Company, together with other industry participants, has appealed to the Ukrainian parliament and authorities to reconsider this royalty, but so far efforts have been unsuccessful.

TRINIDAD

Production from the Company's 25% interest in the Icacos block onshore Trinidad averaged 5 barrels per day during 2005. Royalties attributable to the government's new sliding scale royalty regime averaged 17% of crude oil revenue. The Company does not expect that any exploration or development will occur on the lease in 2006. Cash flow from this interest amounted to $31,493 in 2005.

NEW WESTERN CANADA THRUST

With the reduced netbacks in Ukraine and the political turmoil that continues to frustrate the Company's activities, the Directors of Kroes, on the advice of Management, decided it was appropriate to diversify the Company's operations into new areas. Considering the political uncertainty and the high resource rent in Ukraine, it is not practical nor economic to seek new projects at this time in Ukraine. It was decided to diversify into western Canada where there is significant activity and opportunity. Early in 2006, a new Joint Venture Agreement covering properties in central Alberta was signed with Montane Resources Ltd., a private Alberta company, whose principals are well experienced in western Canada and have been successful in building shallow gas production in the area covered by the Agreement. The format of the arrangement with Montane is for Kroes to earn a 25% interest in each prospect by paying a portion of land and/or seismic costs incurred to date, or a portion of new seismic, if required. Kroes will subsequently pay 25% of drilling and completion costs. Two prospects have been selected to kick off the program and field activity is expected to commence in May. Kroes expects to participate in up to 10 prospects over the next 12 months. The Company plans to raise $2 million in new equity funds to finance its share of Joint Venture activity over the first 12-18 months.

With the slow and steady growth and solid asset base in Ukraine, and with the addition of new projects in Alberta, we anticipate a more active and profitable future for Kroes Energy. In the longer term, we expect the situation in Ukraine to improve economically which will hopefully allow the Company to expand its operations there. In the meanwhile we will look for near term growth on the domestic front.

UKRAINIAN ACTIVITY

During 2005, three new wells were put onstream in the Lelyaki oilfield. No. 305 began producing in May 2005 from the deeper K1 zone and while initial production rates were excellent, the well has now stabilized at about 25 barrels per day. Well No. 302 also was completed in the K1

zone, but the sands at this location were tighter and production is averaging only 15 barrels per day. Well No. 301 began producing in November and is averaging in excess of 50 barrels per day. At Kroes 45% interest, these wells added 40 barrels per day of production during the year.

Well No. 303 began drilling in October 2005 and from the 1,480 meter level, was deviated so that it entered the P1/P2 and K1 productive zones at a 75-degree angle. There was 5 meters of vertical pay in each zone but the deviation resulted in the exposure of 23 meters of pay in each zone and 19 meters have been perforated in the K-1 zone. The well is presently being tested from the K1.

Wells 305, 302, 301 and 303 were completed in the deeper K1 zone and all will eventually be recompleted in the higher P1/P2 zone where approximately 11 meters of pay was present in each well.

In view of the new royalty on production in Ukraine, the Kashtan joint venture is awaiting the impact of the recent election results and reviewing the project economics before establishing the drilling program for 2006. At present oil prices, it is expected that drilling will continue, but discussions will be sought with the new government Ministers before committing to a program.

With the continuing turmoil and turnover in the government and bureaucracy, the agreement with Naftogas to acquire the Ukrainians' 55% of the Kashtan joint venture has not been completed, nor has Kashtan reached agreement with the 55% partner, Ukrnafta, to take over operation of the Lelyaki oilfield. We continue to press these matters with the appropriate officials, but have yet to see any action. On the positive side, we have had no indication that the agreements will not eventually be honoured.

CRUDE OIL RESERVES

As at December 31, 2005 PetroGlobe Canada Ltd. completed an updated reserve report for the Company's 45% interest in the Lelyaki oil field, Ukraine. Proved and probable reserves before royalty declined from 12.8 million barrels estimated in the 2004 report to 10.2 million barrels at year-end 2005. The decline is mainly attributable to lower than anticipated production from wells in the northwest part of the field and reduced oil saturation in the K1 zone "attic" oil. In addition, possible reserves are estimated at 9.0 million barrels. Despite the drop in reserve volumes, the new constant dollar present value of proved and probable reserves, discounted at 10% after taxes totals $67.8 million dollars, over $2.00 per share. Additional information and analysis of the reserves volumes and values is provided on pages five to nine of this Annual Report.

CORPORATE

Normal Course Issuer Bid

On July 11, Kroes Energy received approval from the TSX Venture Exchange for a normal course issuer bid to purchase up to 10% of the Company's public float, extending a similar bid that expired on July 11. The bid was extended because the Directors believe the current share price still is well below the intrinsic net asset value of the Company. During 2005, the Company purchased 137,500 shares at an average price of $0.48 per share.

In June, the Company received a dividend from Kashtan Petroleum Ltd., its 45% owned joint venture in Ukraine. After deducting a 5% withholding tax in Ukraine, Kroes received $177,000 in its Calgary account. This is the third annual dividend the Company has received and brings the total cash return to $669,000. A further dividend payment is expected in mid year 2006.

On June 2, 2005 Kroes Energy Inc. granted incentive stock options to officers, directors and consultants of the Company for the purchase of 975,000 common shares at $0.56 per share. The options have a term of five years and will vest at one-third each year over the first three years of the award. Under its option plan, Kroes can issue up to 10% of the number of shares outstanding and, prior to this grant, there were 1,285,000 shares available for the issue of options.

Mr. Stephen Benediktson retired as a Director of Kroes Energy during 2005 after nine years of involvement, including co-founding the Company. The Management and Directors of the Company are grateful for the many years of valuable advice and leadership provided by Mr. Benediktson.

In February 2006, Mr. C. James Cummings joined the Board of Kroes. The Company is delighted to have the benefit of Mr. Cummings' many years of international legal experience.

The Company would also like to acknowledge the many years of dedicated service provided by Mr. Richard Wilson in his capacity of Corporate Secretary. Mr. Wilson tendered his resignation in April and has been replaced by Mr. Stewart Gossen who also holds the position of Vice President Business Development with the Company.

F. Callaway, President
April 26, 2006

Operations Review

RESERVES

PetroGlobe (Canada) Ltd. has completed its annual update of reserves for the Lelyaki oilfield in Ukraine, effective December 31, 2005. The report was prepared in accordance with the requirements established by National Instrument 51-101 and a detailed analysis is available in the Company's Annual Information Form that has been filed on SEDAR and is available on request.

A summary of key reserves information, as derived from the PetroGlobe report, is presented below. The volume of Kroes' share of proved reserves, before royalties and after adjusting for production during 2005, reserve additions from new wells and technical revisions, are estimated at 6.4 million barrels at December 31, 2005, a reduction of 30% compared to the previous year. This reduction reflects lower reserves from the northwest quadrant of the Lelyaki oilfield due to poorer well productivity rates and lower oil saturation in certain zones. Proved plus probable reserves, before royalties, are estimated at 10.2 million barrels at December 31, 2005, a 20% reduction compared to 2004.

KROES ENERGY INC.
ESTIMATED RESERVES FOR LELYAKI FIELD
AS OF DECEMBER 31, 2005

	Light and Medium Oil	
Kroes' 45% Share	**Gross** *Barrels*	**Net** *Barrels*
Proved		
Producing	934,000	547,000
Undeveloped	5,497,000	3,218,000
Total Proved	6,431,000	3,765,000
Probable	3,777,000	2,212,000
Proved Plus Probable	10,208,000	5,977,000
Possible	8,986,000	5,261,000
Proved, Probable and Possible	19,194,000	11,238,000

Prior to 2005, production from the Lelyaki oilfield was not subject to royalty. The Ukrainian government introduced a new royalty regime early in 2005 which started out at modest levels, but after successive increases, now represents 41.45% of gross revenue. After accounting for this new royalty, Kroes' share of net proved reserves at year end 2005 was 3.8 million barrels, net proved plus probable reserves were 6.0 million barrels and net proved plus probable plus possible reserves were 11.2 million barrels.

KROES ENERGY INC.
RESERVES RECONCILATION
LELYAKI FIELD, UKRAINE

	Light and Medium Oil		
	Barrels		
Kroes' 45% Share	**Net Proved**	**Net Probable**	**Net Possible**
Remaining Reserves @ 2004/12/31	9,156,000	3,672,000	9,324,000
Implementation of Royalty Regime	(3,795,000)	(1,522,000)	(3,865,000)
2005 Production	(56,000)		
Technical Revisions	(1,604,000)	62,000	(198,000)
New Wells	64,000		
Remaining Reserves @ 2005/12/31	3,765,000	2,212,000	5,261,000

KROES ENERGY INC.
NET PRESENT VALUE OF FUTURE NET RESERVES
LELYAKI FIELD, UKRAINE
AS OF DECEMBER 31, 2005

Constant Prices and Costs	**Before Tax** (Cdn $000)		**After Tax** (Cdn $000)	
	0%	10%	0%	10%
Proved				
Producing	21,328	13,129	15,960	9,820
Undeveloped	121,473	42,494	90,964	31,548
Total Proved	142,801	55,623	106,924	41,368
Proved + Probable	235,062	90,925	176,118	67,845
Proved + Probable + Possible	440,572	152,915	330,158	114,252

The Company has estimated the net present value of future net revenues from its share of reserves and production from the Lelyaki oilfield in Ukraine using constant prices and costs based on December 2005 actual financial results. The price used in this calculation is US $54.28 per barrel and operating costs are US $8.60 per barrel. Values have been converted to Canadian dollars using an exchange rate of 1.163.

KROES ENERGY INC.
NET PRESENT VALUE OF FUTURE NET REVENUES
LELYAKI FIELD, UKRAINE
FORECAST PRICES AND COSTS
AS OF DECEMBER 31, 2005

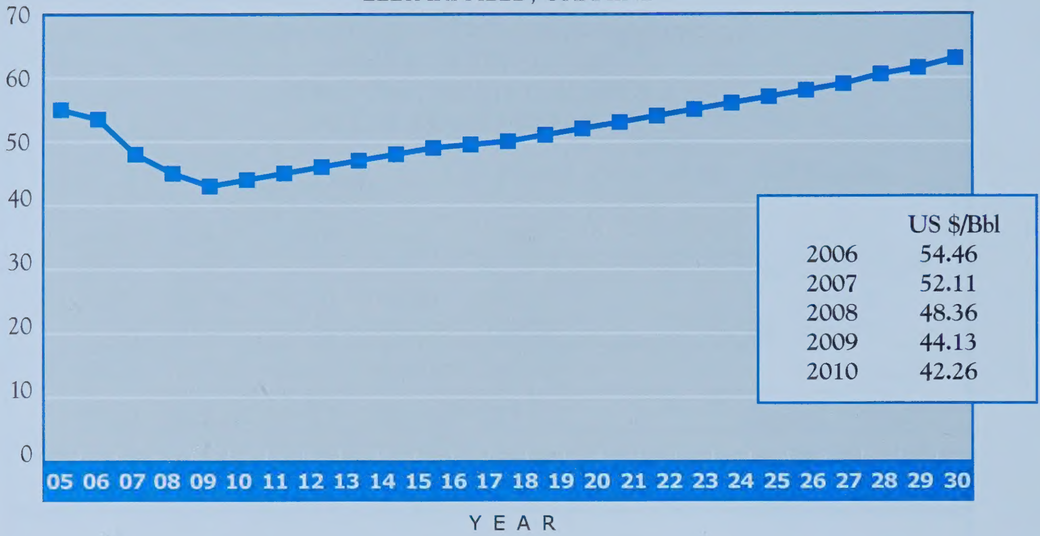
	Before Tax (Cdn$000)				
	0%	5%	10%	15%	20%
Proved Reserves					
Producing	16,010	12,488	10,259	8,742	7,650
Undeveloped	90,174	48,994	28,602	17,622	11,288
Total Proved	106,184	61,482	38,861	26,364	18,938
Proved + Probable	178,483	103,264	65,365	44,467	32,049
Proved + Probable + Possible	343,934	187,591	112,442	72,879	50,372

KROES ENERGY INC.
NET PRESENT VALUE OF FUTURE NET REVENUES
LELYAKI FIELD, UKRAINE
FORECAST PRICES AND COSTS
AS OF DECEMBER 31, 2005

	After Tax (Cdn$000)				
	0%	5%	10%	15%	20%
Proved Reserves					
Producing	11,956	9,328	7,663	6,530	5,717
Undeveloped	67,470	36,444	21,107	12,869	8,131
Total Proved	79,426	45,772	28,770	19,399	13,848
Proved + Probable	133,652	77,108	48,649	32,979	23,680
Proved + Probable + Possible	257,627	140,235	83,857	54,211	37,365

The Company has also estimated its share of future net revenues from the Lelyaki oilfield in Ukraine using forecast prices and costs developed by the Company's independent engineers. A graph of forecast prices is shown on the following page. Costs are assumed to escalate at 1.5% per year beginning in 2005. An exchange rate of 1.163 has been assumed when converting from $US dollars to Canadian dollars.

FORECAST CRUDE OIL PRICES
LELYAKI FIELD, UKRAINE



NET ASSET VALUE
AS AT DECEMBER 31, 2005
$000

	Net Present Value			
	Forecast Prices		Constant Price	
	10%	15%	10%	15%
Working Capital and Restricted Cash	$2,514	$2,514	$2,514	$2,514
Proceeds from Future Exercise of Stock Options	968	968	968	968
Proven plus Probable Reserves	48,649	32,979	67,845	46,817
Net Asset Value	$52,131	$36,461	$71,327	$50,299
Per Share **	$1.48	$1.04	$2.03	$1.43

Conversion Rate $1.00 US = $1.163 Cdn
*** 35,083,488 shares fully diluted*

Management has developed an analysis of the net asset value of the Company as at December 31, 2005. This analysis reflects a range of values based on both constant prices and forecast prices and costs and discount factors of 10% and 15%. The resulting values range from a low estimate of Cdn. $1.04 per share to a high value of Cdn. $2.03 per share based on the number of fully diluted shares at year end.

Form 51 –101F3

REPORT OF MANAGEMENT AND DIRECTORS ON OIL AND GAS DISCLOSURE

Management of Kroes Energy Inc. (the "Company") is responsible for the preparation and disclosure of information with respect to the Company's oil and gas activities in accordance with securities regulatory requirements. This information includes reserves data, which consist of the following:

a) proved and probable oil and gas reserve quantities estimated as at December 31, 2005 using forecast and constant prices and costs; and
b) the related standardized measure of discounted future net cash flows.

Independent qualified reserves evaluators have evaluated the Company's reserves data. The report of PetroGlobe (Canada) Ltd. ("PetroGlobe") will be filed with securities regulatory authorities concurrently with this report.

The Board of Directors of the Company has

a) reviewed the Company's procedures for providing information to PetroGlobe
b) met with PetroGlobe to determine whether any restrictions affected the ability of PetroGlobe to report without reservation; and
c) reviewed the reserves data with management and PetroGlobe.

The Board of Directors has reviewed the Company's procedures for assembling and reporting other information associated with oil and gas activities and has reviewed that information with management. The Board of Directors has approved

a) the content and filing with securities regulatory authorities of the reserves data and other oil and gas information;
b) the filing of the report of PetroGlobe on the reserves data; and
c) the content and filing of this report.

Because the reserves data are based on judgments regarding future events, actual results will vary and the variations may be material.

"Fred Callaway"
Fred Callaway, President & CEO

"S.D. Gossen"
S. D. Gossen, Vice President

"D.M. Zakreski"
D. M. Zakreski, Director

"D.E. Powell"
D. E. Powell, Director

DATED at the City of Calgary, in the Province of Alberta, this 25th day of April, 2006.

Management's Discussion and Analysis

OVERVIEW

Kroes Energy Inc. is an independent, public company actively engaged in the development and production of oil in Ukraine and Trinidad. Kroes' 45% interest in the Lelyaki oilfield, Ukraine was acquired on December 31, 2002 with the acquisition of Zhoda 2001 Corporation, a wholly owned subsidiary.

RESULTS OF OPERATIONS

	2005	2004
Cash Flow	$ 1,289,545	$ 1,031,222
Per Share - Basic	$ 0.040	$ 0.033
- Diluted	$ 0.039	$ 0.032
Net Earnings	$ 806,414	$ 756,834
Per Share - Basic	$ 0.025	$ 0.024
- Diluted	$ 0.024	$ 0.023
Weighted Average Shares Outstanding		
- Basic	32,231,336	31,125,607
- Diluted	33,383,069	32,352,054

Cash flow as commonly used in the oil and gas industry represents net earnings before depletion and depreciation, asset retirement expenses and other non-cash expenses.

Consolidated cash flow for 2005 amounted to $1,289,545, an increase of 25% from the prior year. Revenues from the Company's Ukraine and Trinidad production increased primarily due to higher prices but new royalties established during the year in both countries took a significant portion of the revenue gain. Operating and administrative costs rose modestly. On a basic weighted average outstanding share basis, cash flow from operations increased to $0.040 in 2005 from $0.033 in 2004.

After the deduction of depletion and depreciation, asset retirement expenses and foreign exchange losses, net earnings in 2005 amounted to $806,414 compared to $756,834 in 2004.

REVENUE & PRODUCTION

Oil and gas revenue increased 42% to $4,626,915 in 2005 from $3,262,956 in 2004. Oil production volumes increased to an average of 246 barrels per day from 241 barrels per day in 2004. Three new wells were put on production during the year and as a result, the production declines experienced in Ukraine in 2004 were reversed and exit production rates increased from

220 barrels per day in December 2004 to 262 barrels per day in December 2005. The average oil price in 2005 was $52.50 per barrel as compared to $34.11 in 2004. The table below sets out the relevant variables for Kroes oil and gas production.

		2005		2004
		Liquids		*Liquids*
P&NG Revenue				
Canada	$	–	$	–
Trinidad	$	90,439	$	46,205
Ukraine	$	4,536,476	$	3,216,751
	$	4,626,915	$	3,262,956
Production Volumes				
Trinidad (Bbls per day)		5		3
Ukraine (Bbls per day)		241		238
		246		241
Ukraine				
Barrels produced		88,002		86,997
Barrels sold		86,476		94,463
Prices per Barrel				
Trinidad	$	54.49	$	38.76
Ukraine	$	52.46	$	34.05
Average	$	52.50	$	34.11

ROYALTIES

In 2005, the Ukraine government imposed an onerous new royalty on production. Effective March 31, 2005, a royalty of 300 hryvnia per tonne ($ 9.00 per barrel) was applied on production and, then was increased to 550 hryvnia per tonne ($14.00 per barrel) effective August 1, 2005. In 2006, the royalty rate was increased to 41.45% of the price received by producers. In 2005, the royalty payments in Ukraine totaled $936,840 compared with no royalties in 2004.

In Trinidad, the government imposed a royalty on onshore operations at a rate varying from 0% to 35%, dependent on crude oil prices. The rate is 35% on prices over $US 49.51 per barrel. In 2005, the royalty payments in Trinidad totaled $15,392 compared with none in 2004.

OPERATING EXPENSES

Consolidated operating costs in 2005 totaled $862,661 compared with costs of $785,942 in 2004. In Ukraine in 2005, the operator increased its contract operating rates and as a result production costs increased 9% to $830,606 from $760,974 in 2004. Ukraine production costs per barrel averaged $9.61 per barrel in 2005 versus $8.06 per barrel in 2004.

The Trinidad production costs totaled $32,054 or $19.31 per barrel in 2005 compared with $24,674 or $20.70 per barrel in 2004.

ADMINISTRATIVE EXPENSES

General and administrative expenses increased to $956,588 in 2005 from $936,064 in 2004. An analysis is contained in the following table.

	2005	2004
Administration & Management Fees	$ 255,366	$ 208,487
Audit Fee	$ 131,148	$ 61,897
Accounting	$ 46,442	$ 68,075
Legal	$ 140,169	$ 216,019
Trustee & Listing Fees	$ 16,398	$ 15,627
Investor Relations & Shareholders Communications	$ 79,382	$ 81,675
Consultant Fees & Expenses	$ 42,016	$ 46,056
Insurance	$ 19,207	$ 17,185
Office Rent	$ 75,342	$ 44,569
Travel	$ 16,909	$ 20,743
Repairs and maintenance	$ 8,021	$ 21,960
Bad debts expense	$ 61,770	$ 45,593
Other	$ 64,418	$ 88,178
	$ 956,588	**$ 936,064**

Administration and management fees increased by $46,879 to $255,366 (2004 - $208,487). This reflects a full year of a modest monthly compensation package for all officers which commenced in 2004. Increased audit reporting requirements resulted in a substantial increase in audit fees. Legal costs were down to $140,169 in 2005 from $216,019 in 2004 reflecting a reduced level of legal work.

STOCK BASED COMPENSATION

Stock based compensation charges are required to be reported under the CICA Handbook section 3870 "Stock-based Compensation". On June 2, 2005, 975,000 options were issued with vesting occurring equally over 3 years. Using a Black-Scholes option-pricing model, a value of $468,812 was determined to be the total compensation value and $166,408 was charged to earnings in 2005. The remaining value of $ 302,404 will be charged to earnings over the next two years as the options vest. In 2004, 200,000 options were issued, and using a Black-Scholes option-

pricing model, the calculated value of $38,149 was charged to earnings as the options vested immediately.

EXCHANGE LOSSES

Zhoda 2001 Corporation, a wholly owned subsidiary of Kroes Energy Inc., has on deposit US $787,500 with the Calyon Bank in Kyiv, Ukraine to provide 105% security for a US $750,000 line of credit the Bank extended to Kashtan Petroleum Ltd. In 2005, the US dollar continued to decline against the Canadian dollar with the December 31, 2005 rate at $1.163 versus the $1.2020 at the start of the year. This resulted in an unrealized foreign exchange loss of $32,051 and when combined with other exchange losses, resulted in a charge of $54,222 to net earnings in 2005. In 2004 the loss related to the line of credit was $75,403 and $118,237 when combined with other exchange losses.

ACCRETION OF RETIREMENT OBLIGATIONS

In 2004, the Company adopted the Canadian accounting standard as outlined in CICA Handbook section 3110, "Asset Retirement Obligations". The Company previously estimated costs of site restoration and abandonment and recognized them in earnings on a unit-of-production basis with a corresponding liability on the balance sheet. Under the new standards, the future cost of abandonments and site restoration are discounted, capitalized and amortized on a unit of production basis against earnings. The yearly accretion of discount of these future abandonment costs is calculated every year and is charged to earnings. In 2005, accretion costs increased to $7,898 from $6,228 for 2004.

DEPLETION AND DEPRECIATION

In 2005, depletion and depreciation costs increased to $276,774 from $154,608 in 2004. This increase is due to the increased capital expenditures in Ukraine in 2005 and 2004 as well as the downward adjustment to reserves in 2005. Capital expenditures were $1,773,450 in 2005 compared to $1,848,826 in 2004.

NETBACKS

In 2005, the average operating netback to the Company was $31.91 per barrel compared to $25.90 in 2004. Ukrainian production had an operating netback of $32.02 per barrel in 2005 compared to $26.00 per barrel in 2004. Trinidad operating netbacks were $25.90 in 2005 compared to $18.06 in 2004.

The table below sets out the consolidated corporate cash flow netbacks for 2005 and 2004.

	2005	2004
	($ per barrel)	
Oil and natural gas sales	$ 52.50	$ 34.11
Royalties	(10.80)	–
Operating expenses	(9.79)	(8.21)
Field operating netback	**31.91**	**25.90**
General and administrative	(10.85)	(9.79)
Income taxes	(6.83)	(5.43)
Other	0.40	0.10
Corporate cash flow netback	**$ 14.63**	**$ 10.78**

PROVISION FOR INCOME TAXES

Income taxes incurred by the Kashtan joint venture in Ukraine were 25% of taxable income with $601,623 being Kroes' 45% share in 2005 compared to $519,225 in 2004. There is no income tax payable in either Canada or Trinidad. Non capital loss carryforwards are estimated to be $2,096,953 in Canada as of December 31, 2005 (2004 - $1,287,206).

LIQUIDITY AND CAPITAL RESOURCE

The Company's operating and investing activities in 2005 were financed by cash flow, exercised options, a dividend declared by the Ukraine joint venture and previous years' working capital.

On December 31, 2005 the Company had consolidated cash on hand of $1,558,406. When combined with the cash flow from operations and the proposed 2006 dividend to be received from Kashtan, the Company will have more than sufficient funds to finance its operations and administration in 2006. Early in 2006, the Company entered into a joint venture agreement to explore and develop shallow gas prospects in a concentrated area of central Alberta in Western Canada and will need additional financing to cover these capital obligations. In this regard, the Company is planning a $2,000,000 financing.

The Company has placed US$787,500 on deposit with Calyon Bank (formerly the Credit Lyonnais Bank Ukraine) at a Canadian dollar cost of $1,239,565 to provide 105% security for a US $750,000 line of credit the Bank has extended to Kashtan Petroleum Ltd. Kashtan will draw down the line of credit as required to finance the development activities and will repay the Bank from operating cash flow. When the line of credit is no longer required by Kashtan, the US $787,500 will

be returned to Kroes. At December 31, 2005 the value of this restricted investment was written down to $955,668 due to the strength of the Canadian dollar.

EFFECTIVENESS OF DISCLOSURE CONTROLS AND PROCEDURES

Kroes has carried out an evaluation under the supervision and with the participation of its Management, including its President and Controller, on the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based upon its evaluation, Kroes concluded that, as of December 31, 2005, the disclosure controls and procedures were effective in all material respects. The term "disclosure controls and procedures" is defined under the Security and Exchange Commission's Exchange Act Rule 13a-15(d) as controls and other procedures of a public company that are designed to ensure both non-financial and financial information required to be disclosed by the company in its periodic reports is recorded, processed, summarized, and reported in a timely fashion.

ACCOUNTING ESTIMATES

Accounting estimates require Management to make assumptions regarding matters that are uncertain at the time the estimate is made and may have a material impact on the financial condition of the Company. A comprehensive discussion of Kroes' significant accounting policies may be found in Note 2 to the consolidated financial statements.

OIL RESERVES

The independent petroleum engineering and geological consulting firm of PetroGlobe (Canada) Ltd. evaluated and reported on Kroes' Ukrainian oil reserves.

The estimation of reserves is a subjective process. Forecasts are based on engineering data, projected future rates of production, and the timing of future expenditures, all of which are subject to numerous uncertainties and various interpretations. The Company expects that its estimates of reserves will change with updated information from the results of future drilling, testing, or production levels. Such revisions could be upwards or downwards. Reserve estimates have a material impact on the depletion and depreciation, asset retirement obligations, and impairment costs, all of which could possibly have a material impact on consolidated net earnings.

Capitalized costs and estimated future expenditures to develop proved reserves, including abandonment costs, are depleted based on the proportion of estimated proved oil and natural gas reserves during the year compared to total proved reserves. Investments in unproved properties

and major development projects are not amortized until proved reserves associated with the projects can be determined or until impairment occurs. If it is determined that properties are impaired, the amount of the impairment is added to the capitalized costs to be amortized.

IMPAIRMENT

In applying the full cost method of accounting, Kroes periodically calculates a ceiling or limitation on the amount that property and equipment may be carried for on the consolidated balance sheets. An impairment exists if the undiscounted future net cash flows from proved reserves at future commodity prices plus the cost of undeveloped properties is less than the carrying value of the capitalized costs. As at December 31, 2005 the ceiling amount calculated was $98 million in excess of the carrying value of the costs capitalized.

If an impairment is found to exist, the impaired properties are written down to their fair value. The fair value of the assets is calculated based on future net cash flows from proved plus probable reserves, discounted at a risk free interest rate using future commodity prices, plus the cost of undeveloped properties. An impairment may result in a material loss for a particular period; however, future depletion and depreciation expense would be reduced as a result.

Assumptions about reserves and future prices are required to calculate future net cash flows. The assumptions made to estimate reserves have been discussed above. There is significant uncertainty regarding forecasting future commodity prices due to economic and political uncertainties. Future prices are derived from a consensus of price forecasts among recognized reserve evaluators. Estimates of future cash flows assume a long term price forecast and current operating costs per boe plus an inflation factor.

ASSET RETIREMENT OBLIGATION

The Company recognizes the fair value of estimated asset retirement obligations on the consolidated balance sheet when a reasonable estimate of fair value can be made. Asset retirement obligations include those legal obligations where the Company will be required to retire tangible long term assets such as well sites, pipelines, and facilities. The asset retirement cost, equal to the initially estimated fair value of the asset retirement obligation, is capitalized as part of the cost of the related long term assets. Increases in the asset retirement obligations resulting from the passage of time are recorded as accretion of asset retirement obligations in the consolidated statement of earnings. Amounts recorded for asset retirement obligations are subject to uncertainty associated with the method, timing, and extent of future retirement activities. Actual payments to settle the obligations may differ from estimated amounts.

Management's Responsibility

The preparation and presentation of the Company's consolidated financial statements and the overall quality of the Company's financial reporting are the responsibility of management. The financial statements have been prepared in accordance with generally accepted accounting principles and necessarily include estimates that are based on management's best judgments. Information contained elsewhere in the Annual Report is consistent, where applicable, with that contained in the financial statements.

Management has designed and maintains an appropriate system of internal controls to provide reasonable assurance that all assets are safeguarded and financial records properly maintained to facilitate the preparation of financial statements.

Grant Thornton LLP, an independent firm of chartered accountants appointed by the shareholders, have conducted an examination of the corporate and accounting records in order to express their opinion on the consolidated financial statements. The Audit Committee has met with representatives of Grant Thornton LLP and management in order to determine if Management has fulfilled its responsibilities in the preparation of the consolidated financial statements. The Audit Committee has reported its findings to the Board of Directors who have approved the consolidated financial statements.

Fred Callaway President	David R. Malarchuk Controller

Auditor's Report

To the Shareholders of
Kroes Energy Inc.

We have audited the consolidated balance sheets of Kroes Energy Inc. as at December 31, 2005 and 2004 and the consolidated statements of operations and retained earnings and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Grant Thornton LLP

Chartered Accountants
Calgary, Alberta
April 14, 2006

Consolidated Balance Sheets

December 31	2005	2004 *Restated (Note 9)*
ASSETS		
Current		
Cash and cash equivalents	$ 1,558,406	$ 2,037,203
Receivables	132,240	180,142
Prepaids and deposits	108,210	36,774
Inventory	61,756	31,526
	1,860,612	2,285,645
Property and equipment (Note 3)	5,082,081	3,740,255
Restricted funds (Note 4)	955,668	961,441
	$ 7,898,361	$ 6,987,341
LIABILITIES		
Current		
Payables and accruals	$ 277,814	$ 189,981
Income taxes payable	117,779	108,944
	395,593	298,925
Asset retirement obligations (Note 5)	114,203	101,534
Future income taxes (Note 9)	258,226	252,452
	768,022	652,911
SHAREHOLDERS' EQUITY		
Capital stock (Note 6)	6,001,721	5,908,835
Contributed surplus (Note 6f)	376,361	255,456
Foreign currency translation adjustment	(832,610)	(647,124)
Retained earnings	1,584,867	817,263
	7,130,339	6,334,430
	$ 7,898,361	$ 6,987,341

Commitment and contingency (Note 13)
Subsequent event (Note 14)
See accompanying notes to the consolidated financial statements.

On behalf of the Board

F. Callaway
Director

D.E. Powell
Director

Consolidated Statements of Operations and Retained Earnings

Year Ended December 31	2005	2004
Revenue		
Oil and natural gas sales	$ 4,626,915	$ 3,262,956
Royalties	(952,232)	–
	3,674,683	3,262,956
Expenses		
Operating	862,661	785,942
General and administrative	956,588	936,064
Stock based compensation	166,408	38,149
Foreign exchange loss	54,222	118,237
Accretion of asset retirement obligations	7,898	6,228
Depletion and depreciation	276,774	154,608
	2,324,551	2,039,228
Earnings before other items and income taxes	1,350,132	1,223,728
Other items		
Interest and other income	57,905	52,331
Earnings before income taxes	1,408,037	1,276,059
Income taxes (Note 9)	601,623	519,225
Net earnings	$ 806,414	$ 756,834
Net earnings per share amounts:		
Basic (Note 7)	$ 0.025	$ 0.024
Diluted (Note 7)	$ 0.024	$ 0.023
Retained earnings, as previously reported	$ 817,263	$ 290,336
Change in accounting policies		
Stock-based compensation	–	(217,307)
Asset retirement obligations	–	37,905
Retained earnings, as restated	817,263	110,934
Net earnings	806,414	756,834
Premium on redemption of common shares (Note 6e)	(38,810)	(50,505)
Retained earnings, end of year	$ 1,584,867	$ 817,263

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Cash Flows

Year Ended December 31	2005	2004
OPERATING		
Net earnings	$ 806,414	$ 756,834
Items not affecting cash		
Depletion and depreciation	276,774	154,608
Accretion of asset retirement obligations	7,898	6,228
Stock based compensation	166,408	38,149
Unrealized foreign exchange loss	32,051	75,403
	1,289,545	1,031,222
Change in non-cash operating working capital (Note 12)	(3,464)	974,497
	1,286,081	2,005,719
FINANCING		
Proceeds from share issues	75,000	1,366,551
Redemption of common shares	(66,428)	(93,880)
	8,572	1,272,671
INVESTING		
Additions to property and equipment	(1,773,450)	(1,848,826)
Net change in cash and cash equivalents	(478,797)	1,429,564
Cash and cash equivalents,		
Beginning of year	2,037,203	607,639
End of year	$ 1,558,406	$ 2,037,203

See accompanying notes to the consolidated financial statements.

Notes to the Consolidated Financial Statements

December 31, 2005

1. Nature of operations

The Company is engaged in the exploration for and production of petroleum and natural gas reserves in Ukraine and Trinidad.

Operations in Ukraine are conducted by JV Kashtan Petroleum Ltd. ("Kashtan"), a limited liability company, registered under the laws of Ukraine.

Kashtan is licensed to extract oil and gas from Lelyaky field in Pryluky District of Chernihiv Region, Ukraine. The operating license is for an initial term of twenty years, expiring in May 2016 and may be extended for a further twenty years with mutual consent of the Partners.

Ukraine continues to display emerging market characteristics and its legislation and business practices regarding banking operations, foreign currency transactions and taxation is constantly evolving as the government attempts to manage the economy. Risks inherent in conducting business in an emerging market economy include, but are not limited to, volatility in the financial markets and the general economy. Uncertainties over the development of the tax and legal environment, as well as difficulties associated with the consistent application of current laws and regulations have continued. Assets based in Ukraine represent approximately 80% of the consolidated assets. The Company's operations and financial position may be affected by these uncertainties.

2. Summary of significant accounting policies

Basis of presentation

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles within the framework of the accounting policies summarized below.

Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Zhoda 2001 Corporation ("Zhoda"). Zhoda has a 45% joint interest in Kashtan. All inter-company transactions and balances are eliminated upon consolidation.

Petroleum and natural gas properties

i) Capitalized costs

The Company follows the full cost method of accounting for its petroleum and natural gas operations as determined by the Canadian Institute of Chartered Accountants ("CICA"), Accounting Guideline 16 ("AcG-16"). Under this method all costs related to the exploration for and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses, and costs of drilling both producing and non-producing wells. Proceeds from the sale of properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would significantly alter the rate of depletion and depreciation.

ii) Depletion and depreciation

Depletion of exploration and development costs and depreciation of production equipment and processing facilities is provided using the unit-of-production method based upon estimated proved petroleum and natural gas reserves. The costs of significant undeveloped properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment has occurred. Estimated future costs to be incurred in developing proved reserves are included in costs subject to depletion. For depletion and depreciation purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

Depreciation of buildings, vehicles and office equipment is provided for on a declining balance method at rates from 5% to 30% per annum which is designed to depreciate the cost of the assets over their estimated useful lives.

iii) Impairment test

At each reporting period the Company performs an impairment test to determine the recoverability of capitalized costs associated with reserves. An impairment loss is recognized in operations when the carrying amount of a cost centre exceeds its fair value. The carrying amount of the cost centre is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows from proved reserves plus the costs of unproved properties. If the sum of the cash flows is less than the carrying amount, the impairment loss is limited to the amount by which the carrying amount exceeds the sum of the fair value of proved and probable reserves and the costs of unproved properties that have been subject to a separate impairment test and contain no probable reserves.

iv) Asset retirement obligations

The Company recognizes the fair value of estimated asset retirement obligations on the consolidated balance sheet when a reasonable estimate of fair value can be made. Asset retirement obligations include those for which a company faces a legal obligation to retire tangible long-lived assets such as well sites, pipelines and facilities. The asset retirement cost, equal to the initially estimated fair value of the asset retirement obligation, is capitalized as part of the cost of the related long lived asset. Changes in the estimated obligation resulting from revisions to estimated timing or amount of undiscounted cash flows are recognized as a change in the asset retirement obligation and the related asset retirement cost.

Asset retirement costs are amortized using the unit-of-production method and are included in depletion and depreciation in the consolidated statement of operations. Increases in the asset retirement obligations resulting from the passage of time are recorded as accretion to the asset retirement obligations in the consolidated statement of operations. Actual expenditures incurred are charged against the accumulated obligations.

Measurement uncertainty

The preparation of the consolidated financial statements in accordance with Canadian generally accepted accounting principles requires management to make certain assumptions and estimates that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from and affect the results reported in these consolidated financial statements as future confirming events occur (see Note 1). Amounts recorded for depletion and depreciation, asset retirement obligations and amounts used in impairment test calculations are based upon estimates of petroleum and natural gas reserves and future costs to develop those reserves. By their nature, these estimates of reserves, costs and related future cash flows are subject to uncertainty, and the impact on the consolidated financial statements of future periods could be material.

The amounts attributable to the fair value of stock options issued are based on estimates of the future volatility of the Company's share price, expected lives of the options, expected dividends and other relevant assumptions (see Note 8).

Joint operations

The majority of the Company's oil and gas exploration, development and production activities are conducted jointly with others. These consolidated financial statements reflect only the Company's proportionate interest in such activities.

Foreign currency translation

i) Self-sustaining foreign operations

All assets and liabilities are translated at the rate of exchange in effect at the balance sheet date. Revenues and expenses are translated at the average exchange rates for the period. Exchange gains and losses arising from the translation are deferred and included in a separate component of shareholders' equity.

ii) Accounts in foreign currencies

Accounts in foreign currencies are translated at the rate of exchange in effect at the balance sheet date. Exchange gains or losses are included in the consolidated statements of operations and retained earnings.

Income taxes

Income taxes are recorded using the liability method of tax allocation. Future income taxes are calculated based on temporary differences arising from the difference between the tax basis of an asset or liability and its carrying value using substantively enacted tax rates anticipated to apply in the periods when the temporary differences are expected to reverse. Changes in income tax rates that are substantively enacted are reflected in the accumulated future income tax balances in the period the change occurs.

Per share amounts

The treasury stock method is used to determine the dilutive effect of stock options and warrants. The treasury stock method assumes that proceeds received from the exercise of in-the-money stock instruments are used to repurchase common shares at the average market price for the year.

Stock-based compensation plan

The Company grants stock options to its directors, officers, consultants and employees upon employment and periodically during the period of employment.

The Company records compensation expense in the consolidated statements of operations for stock options granted to directors, officers and employees using the fair value method. Compensation costs are recognized over the vesting period. Fair values are determined using the Black-Scholes option pricing model.

Financial instruments

Financial instruments of the Company consist mainly of cash and cash equivalents, receivables and payables and accruals. Unless otherwise disclosed, there are no significant differences between the carrying value of these financial instruments and their estimated fair value.

Cash and cash equivalents

Cash and cash equivalents are comprised of cash on hand, balances with banks and short-term deposits with a duration of three months or less. Bank borrowings are considered to be financing activities.

Inventory

Inventory is valued at the lower of cost and estimated net realizable value. Cost is determined on a weighted average basis.

Revenue recognition

Oil and natural gas sales are recognized in earnings when reserves are delivered to the purchaser.

Functional currency

The functional currency for the consolidated group is as follows:

The operations in Ukraine have a functional currency of Hryvnias; and
The operations in Canada have a functional currency of Canadian dollars.

The Company has chosen the Canadian dollar as its reporting currency for the consolidated group.

3. Property and equipment

		2005	
	Cost	Accumulated Depletion and Depreciation	Net Book Value
Exploration and development costs	$ 2,678,987	$ 242,511	$ 2,436,476
Production equipment and processing facilities	2,984,430	427,754	2,556,676
Office equipment	63,889	37,240	26,649
Retirement costs of long lived assets	79,566	17,286	62,280
	$ 5,806,872	$ 724,791	$ 5,082,081

		2004 (Restated Note 9)	
	Cost	Accumulated Depletion and Depreciation	Net Book Value
Exploration and development costs	$ 2,495,550	$ 137,873	$ 2,357,677
Production equipment and processing facilities	1,579,265	293,472	1,285,793
Office equipment	60,131	22,555	37,576
Retirement costs of long lived assets	74,795	15,586	59,209
	$ 4,209,741	$ 469,486	$ 3,740,255

Future capital expenditures of $17,072,000 (2004 - $11,725,000), as estimated by independent engineers, relating to the development of proved reserves in Ukraine have been included in costs subject to depletion. Undeveloped properties in Ukraine with a cost at December 31, 2005 of $1,067,000 (2004 - $1,007,000) included in exploration and development costs, have not been subject to depletion.

Included in the carrying value of exploration and development costs is the carrying value associated with the Trinidad assets of $352,324 (2004 - $352,905). Of this amount, properties with a carrying value of $348,036 (2004 - $347,878) are considered unproved properties and not subject to depletion.

The prices used in the impairment test evaluation of the Company's petroleum properties were as follows:

	2006	2007	2008	2009	2010	2011	2012	Increase Thereafter
Crude oil per BBL ($US)	$ 54.46	$ 52.11	$ 48.36	$ 44.13	$ 42.26	$ 42.99	$ 44.13	2.0%

4. Bank indebtedness

The Company has negotiated an operating line of credit to a maximum of $750,000 U.S. bearing interest at LIBOR plus 1.75% for Kashtan. As security for the operating line, the Company was required to deposit $787,500 U.S. with the financial institution. At December 31, 2005, there were no draws (2004 – $Nil) on the operating line. As at December 31, 2005, the Canadian dollar value of the deposit was $955,668 (2004 - $961,441).

The restricted funds will remain on deposit until the Kashtan joint venture is self financing at which time the funds will be returned to the Company.

5. Asset retirement obligations

The following table represents the reconciliation of the beginning and ending aggregate carrying amount of the obligations associated with the retirement of oil and gas assets:

	2005	2004
Asset retirement obligations, beginning of year	$ 101,534	$ 92,324
Liabilities incurred	11,589	2,982
Accretion expense	7,898	6,228
Revision of estimates	(6,818)	-
Asset retirement obligations, end of year	$ 114,203	$ 101,534

The total undiscounted amount of estimated cash flows required to settle the obligation is $697,894 (2004 - $383,368), which has been discounted using a credit-adjusted risk free rate of 8%. The majority of these obligations are not expected to be settled for years, or decades in the future and will be funded from general Company resources at the time of retirement and removal.

6. Capital stock

a) Authorized:

Unlimited number of common shares
Unlimited number of preferred shares issuable in series

b) Issued and outstanding:

	2005		2004	
	Number of Shares	Amount	Number of Shares	Amount
Common shares				
Balance, beginning of year	32,000,988	$ 5,908,835	27,561,808	$ 4,585,659
Issued for cash on exercise of options	300,000	75,000	–	–
Transfer of carrying value on exercise of options	–	45,503	–	–
Issued for cash on exercise of warrants	–	–	4,658,180	1,369,255
Purchased through Issuer's bid process	(137,500)	(27,617)	(219,000)	(43,375)
Share issue costs	–	–	–	(2,704)
Balance, end of year	32,163,488	$ 6,001,721	32,000,988	$ 5,908,835

c) Escrowed shares:

The shares issued for the purchase of Zhoda are pursuant to an escrow agreement. On closing of the acquisition of Zhoda, the TSX Venture Exchange ("Exchange") required the 8,600,000 common shares issued as consideration to be placed in escrow using its Value Security Escrow Agreement. This agreement provided for the release of 10% of the escrowed shares on January 17, 2003 and 15% on each following six month periods. At December 31, 2005, all shares had been released from escrow. Prior to each release, the Exchange requires confirmation that the Ukrainian joint venture interest is in good standing and that there is no indication it will be impaired or written off.

d) Purchase warrants:

In 2002, 6,399,800 warrants to purchase common shares were issued in connection with a public financing. Each warrant entitled the holder to purchase one common share for $0.30 prior to February 29, 2004 During 2004, 4,094,200 warrants were exercised for total cash proceeds of $1,228,260 (2003 - 166,000 warrants were exercised for proceeds of $49,800). The remaining 2,139,600 warrants expired.

In 2002 as part of the public financing, the agent received 604,980 warrants to purchase common shares. Each warrant entitled the agent to acquire one common share $0.25 per warrant until August 29, 2004. During 2004, 563,980 warrants were exercised for total cash proceeds of $140,995. The remaining 41,000 warrants expired.

e) Normal course issuer bid:

Effective July 13, 2004, the Company received approval from the TSX Venture Exchange for a Normal Course Issuer Bid (the "Bid"). Under the Bid, the Company could purchase for cancellation up to 2,045,000 of its common shares, representing 6% of the common shares outstanding. The Bid was renewed in July 2005.

During the year, the Company purchased for cancellation 137,500 common shares at an average price of $0.48 per share (2004 -219,000 common shares at an average price of $0.43 per share) pursuant to the Bid. The excess of the purchase price over book value has been charged to retained earnings.

f) Contributed surplus:

	2005	2004
Balance, beginning of year	$ 255,456	$ 217,307
Value attributed to stock options granted	166,408	38,149
Transfer of carrying value of exercised options	(45,503)	–
Balance, end of year	$ 376,361	$ 255,456

7. Per share information

Basic net earnings per common share is computed by dividing net earnings by the weighted average number of common shares outstanding for the year. Diluted net earnings per common share is computed by dividing net earnings by the diluted weighted average number of common shares outstanding for the year. In the calculation of diluted per share amounts, options under the stock option plan and purchase warrants are assumed to have been converted or exercised on the later of the beginning of the year or the date granted. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares.

	2005	2004
Weighted average shares outstanding:		
Basic	32,231,336	31,125,607
Shares issued pursuant to options and warrants	1,151,733	1,226,447
Diluted	33,383,069	32,352,054
Net earnings per common share:		
Basic	$ 0.025	$ 0.024
Diluted	$ 0.024	$ 0.023

In the 2005 calculation of diluted weighted average shares outstanding, 975,000 options (2004 - Nil) were excluded from the calculations, as they were anti-dilutive.

8. Stock-based compensation plan

The Company grants stock options to its directors, officers and consultants. The Company has a policy of reserving up to 10% of the outstanding common shares for issuance to eligible participants. At December 31, 2005, there were 3,216,349 (2004 – 3,200,099) common shares reserved for this purpose. All options issued prior to January 1, 2005 vested immediately upon being granted while the 2005 options granted vest equally over three years on the anniversary date of issuance.

At December 31, 2005, 2,920,000 options (2004 – 2,245,000), with exercise prices ranging from of $0.13 to $0.56 were outstanding and exercisable at various dates to June 1, 2010. The exercise price of each option granted was equal to or higher than the closing market price of the Company's common shares on the day prior to the issuing of the option.

The following tables summarize the information about the stock options:

	2005		2004	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	2,245,000	$ 0.22	2,045,000	$ 0.21
Granted	975,000	$ 0.56	200,000	$ 0.33
Exercised	(300,000)	$ 0.25	–	–
Outstanding, end of year	2,920,000	$ 0.33	2,245,000	$ 0.22
Options exercisable, end of year	1,945,000	$ 0.22	2,245,000	$ 0.22

	Outstanding Options			Exercisable Options	
Range of Exercise Prices	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Years to Expiry	Number of Options Exercisable	Weighted Average Exercise Price
$ 0.13	670,000	$ 0.13	1.9	670,000	$ 0.13
$ 0.25	1,075,000	$ 0.25	3.2	1,075,000	$ 0.25
$ 0.33	200,000	$ 0.33	4.0	200,000	$ 0.33
$ 0.56	975,000	$ 0.56	4.5	–	–
	2,920,000	$ 0.33	3.0	1,945,000	$ 0.22

The weighted average fair market value of options granted during the year ended December 31, 2005 is $0.48 (2004 - $0.19) per option. The fair value of each option granted was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions.

	2005	2004
Risk-free interest rate	3.20%	3.37%
Estimated hold period prior to exercise (years)	5	5
Volatility in the price of the Company's common shares	128%	67%
Dividend yield	0%	0%

9. Income taxes

a) Provision for income taxes

	2005	2004
Earnings before income taxes	$ 1,408,037	$ 1,276,059
Expected tax expense at combined federal and provincial rate of 37.62% (2004 - 38.62%)	$ 529,704	$ 492,814
Increase (decrease) resulting from:		
Statutory tax rate differences	(280,060)	(223,934)
Tax rate reductions	94,907	14,863
Stock based compensation	62,603	14,733
Other	50,090	(30,778)
Valuation allowance	144,379	251,527
Provision for income taxes	$ 601,623	$ 519,225
Provision for income taxes:		
Current	$ 601,623	$ 519,225
Future	–	–
	$ 601,623	$ 519,225

b) Future income taxes

Future income taxes consist of the following temporary differences:

		2005		2004 (Restated)
Ukrainian property and equipment	$	(258,226)	$	(252,452)
Canadian property and equipment		128,004		143,433
Non-capital losses		704,996		497,119
Share issue costs		6,043		53,294
Asset retirement obligations		38,395		39,213
		619,212		480,607
Valuation allowance		(877,438)		(733,059)
Future income taxes	$	(258,226)	$	(252,452)

c) Restatement of prior periods

During 2005, it was determined that the future income tax liability related to the taxable temporary difference of Zhoda's 45% joint interest in Kashtan were not correctly determined. The 2004 consolidated financial statements have been restated to reflect the following adjustments:

	Change Increase (decrease)			
		2005		2004
Assets				
Property and equipment	$	252,452	$	252,452
Liabilities				
Future income taxes	$	258,226	$	252,452
Shareholders' equity				
Foreign currency translation adjustment	$	5,774	$	–
Net earnings and retained earnings	$	–	$	–

d) Tax losses available

The Company has incurred losses for Canadian income tax purposes of approximately $2,096,953 (2004 - $1,287,206), the related benefit of these losses has not been recognized in the consolidated financial statements. Unless sufficient taxable income is earned these losses will expire as follows:

2007	$	28,344
2008		144,899
2009		119,330
2010		170,012
2014		824,621
2015		809,747

10. Geographic segments

The Company is organized into divisions by geographic area consisting of Canada, Trinidad and Ukraine. The Trinidad and Ukraine divisions derive revenue from oil and gas properties.

	Canada	Trinidad	Ukraine	2005 Total
Oil and gas revenue, net	$ –	$ 75,047	$ 3,599,636	$ 3,674,683
Net earnings (loss)	(879,281)	28,908	1,656,787	806,414
Property and equipment	20,389	361,333	4,700,359	5,082,081
Identifiable assets	520,261	523,461	6,854,639*	7,898,361

	Canada	Trinidad	Ukraine	2004 (Restated) Total
Oil and gas revenue, net	$ –	$ 46,205	$ 3,216,751	$ 3,262,956
Net earnings (loss)	(702,934)	4,883	1,454,885	756,834
Property and equipment	24,945	361,437	3,353,873	3,740,255
Identifiable assets	1,161,703	479,274	5,346,364*	6,987,341

* Includes the restricted funds related to Ukraine (see Note 4).

11. Financial instruments

Credit risk

The Company, in the normal course of business, monitors the financial condition of its customers and reviews credit history of each new customer. The Company establishes an allowance for doubtful accounts that corresponds to the specific credit risk of its customers, historical trends and economic circumstances. The allowance as at December 31, 2005 is $61,770 (2004 - $Nil) and is included in the consolidated statements of operations in the general and administrative expenses.

Foreign currency risk

The Company has cash and cash equivalents, receivables, and payables and accruals denominated in foreign currencies, and thus are exposed to the financial risk of earnings fluctuations arising from changes in foreign exchange rates and the degree of volatility of these rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

Sales within Ukraine by Kashtan are by law denominated in local currency (Hryvnia). Funds for repatriation back to Canada are then converted to, and transmitted in, U.S. dollars. Regulations imposed by the Ukrainian authorities are subject to ongoing change.

12. Supplemental cash flow information

	2005	2004
Change in non-cash working capital:		
Receivables	$ 47,902	$ 514,216
Prepaids and deposits	(71,436)	(19,264)
Inventory	(30,230)	407,189
Payables and accruals	87,833	34,731
Income taxes payable	8,835	85,438
	42,904	1,022,310
Adjustment for unrealized foreign exchange in above items	(46,368)	(47,813)
	$ (3,464)	$ 974,497
Cash and cash equivalents consist of:		
Cash on hand and balances with banks	$ 1,558,406	$ 2,037,203
Income taxes paid	$ 602,785	$ 433,787

13. Commitment and contingency

a) The Company has committed to monthly rental payments for office premises until February 2010 as follows:

2006	$ 59,172
2007	$ 60,713
2008	$ 60,713
2009	$ 61,814
2010	$ 60,715

b) The Company is a defendant in legal claims associated with normal operations. These claims, although unresolved at the current time, in management's opinion are not expected to have a material impact on the financial position or results of operations of the Company. The Company has not made any accrual for expected losses as in their opinion the claims are not warranted.

14. Subsequent event

On March 22, 2006, the Company granted incentive stock options to a newly appointed Director of the Company for the purchase of 100,000 common shares at $0.345 per share. The options vest equally over the next three years and have a term of five years.

15. Comparative amounts

Certain comparative figures have been reclassed to conform to the presentation adopted in the current year.

Quarterly Information

	Q1	Q2	Q3	Q4	Total
2005					
Financial					
Oil and gas gross revenue	$390,492	$1,257,491	$1,567,245	$1,411,687	$4,626,915
Cash flow from operations	$149,738	$445,517	$540,321	$153,969	$1,289,545
$ per weighted share outstanding	$0.005	$0.014	$0.016	$0.005	$0.040
$ per weighted share fully diluted	$0.004	$0.014	$0.016	$0.005	$0.039
Net income	$102,681	$322,664	$374,226	$6,843	$806,414
$ per weighted share outstanding	$0.003	$0.010	$0.012	–	$0.025
$ per weighted share fully diluted	$0.003	$0.010	$0.011	–	$0.024
Operating					
Liquids production (Bbl/d)	209	246	268	259	246
Liquids price $/bbl - Ukraine	$43.98	$49.44	$57.61	$57.31	$52.46
Liquids price $/bbl - Trinidad	$46.82	$55.41	$61.33	$56.27	$54.49
2004					
Financial					
Oil and gas gross revenue	$932,818	$535,213	$1,022,548	$772,377	$3,262,956
Cash flow from operations	$392,029	$139,803	$407,284	$92,106	$1,031,222
$ per weighted share outstanding	$0.013	$0.005	$0.013	$0.003	$0.033
$ per weighted share fully diluted	$0.013	$0.004	$0.012	$0.003	$0.032
Net income (loss)	$315,927	$121,222	$324,328	($4,643)	$756,834
$ per weighted share outstanding	$0.011	$0.005	$0.010	–	$0.024
$ per weighted share fully diluted	$0.011	$0.004	$0.010	–	$0.023
Operating					
Liquids production (Bbl/d)	258	241	215	229	241
Liquids price $/bbl - Ukraine	$36.37	$49.44	$48.59	$43.97	$42.57
Liquids price $/bbl - Trinidad	$36.82	$36.69	$44.75	$36.64	$38.76

Five Year Summary

	2005	2004 (Restated)	2003 (Restated)	2002	2001
Income Statement					
Gross net revenue	$4,626,915	$3,262,956	$3,032,135	$665,784	$734,193
Total net revenue	$3,674,683	$3,262,956	$3,000,736	$632,669	$695,175
Other items	$57,905	$52,331	$579,740	$1,915	$10,182
Operating expenses	$862,661	$785,942	$888,007	$408,549	$421,576
General & administrative expenses	$956,588	$936,064	$493,339	$147,198	$122,616
Stock-based compensation	$166,408	$38,149	$217,307	–	–
Interest				$2,078	$9,527
Foreign exchange losses (gains)	$54,222	$118,237	$249,403	–	–
Depletion and other provisions	$284,672	$160,836	$314,530	$28,914	$629,559
Total expenses	$2,324,551	$2,039,228	$2,162,586	$586,739	$1,183,278
Income tax	$601,623	$519,225	$398,774	$373,700	–
Net income (loss)	$806,414	$756,834	$1,019,116	($325,855)	($477,921)
$ per weighted share outstanding	$0.025	$0.024	$0.037	($0.024)	($0.040)
$ per weighted share fully diluted	$0.024	$0.023	$0.037	($0.024)	($0.040)
Balance Sheet					
Working capital	$1,465,019	$1,986,720	$1,579,466	$874,860	$164,253
Restricted funds on deposit	955,668	961,441	1,028,586	827,282	–
Properties and equipment - net	5,082,081	3,740,255	2,022,905	1,937,632	559,713
Other assets	–	–	–	–	894,880
Total assets	$7,502,768	$6,688,416	$4,630,957	$3,639,774	$1,618,846
Asset retirement obligations	114,203	101,534	92,324	117,749	55,249
Future income taxes	258,226	252,452	–	–	–
Convertible debenture	–	–	–	–	24,530
Equity	7,130,339	6,334,430	4,538,633	3,522,025	1,539,067
Total liabilities and equity	$7,502,768	$6,688,416	$4,630,957	$3,639,774	$1,618,846
Common Shares - December 31,					
Outstanding	32,163,488	32,000,988	27,561,808	26,915,808	11,749,341
Fully diluted	35,083,488	34,245,988	36,611,588	35,070,588	13,056,007
Barrels of oil equivalent:					
Sales (Bbls)	88,135	95,655	82,279	17,155	18,122
Produced (Bbls)	89,645	88,195	107,108	17,155	18,122
Produced Daily average (Bbls/day)	246	241	293	50	50

Corporate Information

OFFICES

1840, 444 - 5th Avenue S.W.
Calgary, Alberta, Canada
T2P 3A8
Tel: (403) 265-7711
Fax: (403) 265-7733

141, 24 Geroiv Stalingradu Avenue
Kyiv, Ukraine 04210k

400 Chin Aleong Street
Block 3, Palmiste
San Fernando, Trinidad, West Indies

BANKERS

Bank of Nova Scotia
Calgary, Alberta

Bank of Nova Scotia
San Fernando
Trinidad, West Indies

Calyon Bank Ukraine
Kyiv, Ukraine

AUDITOR

Grant Thornton LLP
Calgary, Alberta

SOLICITORS

Dunphy Best Blocksom LLP
Calgary, Alberta

TRANSFER AGENT

Computershare Trust Company of Canada
Calgary, Alberta

Stock Exchange Listing
TSX Venture Exchange Symbol: KRS

INVESTOR RELATIONS

CHF Investor Relations Inc.
Olav Svela, Vice President
Tel: 416-868-1079
Fax: 416-868-6198
olav@chfir.com

DIRECTORS AND OFFICERS

Fred Callaway, C.A.
President and Director
Former Vice President of Home Oil Company

Edward M. Southern
Executive Vice President and Director
Honorary Consul of Ukraine for Alberta, Chairman of Energy Sector of the Canada-Ukraine Intergovernmental Economic Commission

C. James Cummings, B.A. L.L.B.
Director
Lawyer and Partner in the firm International Energy Counsel

Stewart D. Gossen, B.A. MBA
Vice President and Secretary
Former Vice President, Enbridge Inc. and Home Oil Company

David Malarchuk, CGA
Controller
Former Financial Manager, Home Oil Company and Corporate Consultant

David Powell, B. Sc., D.I.C., FGS
Director
Former Chairman, Talisman Energy Inc. and former President/CEO of Home Oil Company Limited

Dr. James E. Werbicki, M.D.
Director
Chief of Emergency Medicine, Saskatoon City Hospital, Saskatoon, Saskatchewan

Darrell M. Zakreski
Director
President, Bullseye Realty Ltd., inner city real estate development

KROES ENERGY INC.
SUITE 1840, 444 - 5 AVENUE S.W.
CALGARY, ALBERTA
T2P 2T8